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SUBJECT: UKRAINE: NEW ENERGY MINISTER TOUTS WESTINGHOUSE-ENERGOATOM
CONTRACT AS A DELIVERABLE

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11. (SBU) Summary: New Energy Minister Yuri Prodan told the Ambassador on January 21 that the GOU hoped to use a possible visit by President Bush in the near future to sign a contract with Westinghouse for the delivery of fuel to Ukraine's nuclear reactors.

Acknowledging that the contract proposed by Westinghouse to state-owned nuclear utility EnergoAtom was complex and new for Ukraine, Prodan nonetheless was confident that negotiations could be completed in time for a possible POTUS visit on the margins of the Bucharest NATO summit in April. The Ambassador agreed that a POTUS visit would be an ideal backdrop for such a landmark signing, and emphasized that no discussion on such a visit had yet been made, but said negotiations should move forward independently of a possible visit. Prodan also said that Ukraine must remove intermediary RosUkrEnergo (RUE) from its gas dealings with Russia, but in the short run had no alternative to RUE because Ukraine could not yet pay the world prices that Russia would demand in direct negotiations. The new head of NaftoHaz did not negotiate gas or transit prices during his recent trip to Moscow, Prodan told the Ambassador. On other topics, Prodan gave his backing to the oil and gas exploration agreement signed by the previous GOU with U.S.-based Vanco, said Ukraine needed to bring municipal heating prices in line with true costs, and came out in favor of large-scale privatization and restructuring of the electricity market in Ukraine. He was non-committal when the Ambassador urged him to keep plans for a central nuclear waste storage facility on track.

12. (SBU) Comment: The surprise statement linking the Westinghouse-EnergoAtom deal to a POTUS visit shows that the new GOU is keen to provide incentives for President Bush to come to Ukraine in the near future. It remains to be seen whether the GOU and EnergoAtom can sift through, negotiate and conclude a complex commercial contract by the self-imposed April deadline that Prodan mentioned, especially as there are likely still some in Energoatom who oppose the deal. The new minister's comments on RUE do not differ in substance from those of former Minister Boyko, and reflect the view that gas bought from the intermediary still remains cheaper than gas Ukraine buys directly from Russia. The economic rationale for RUE will soon disappear as the prices Ukraine pays for imported gas approach European levels. Prodan generally has moderate pro-reform credentials on account of his previous track record in the energy sector and his lack of cozy ties to many of the more nefarious players in the sector, although his ties as a deputy to former Minister Plachkov (who was in charge during the January 2006 gas deal) do not inspire great confidence in us. End summary and comment.

13. (SBU) During their January 21 introduction meeting, Minister of Fuel and Energy Yuriy Prodan told the Ambassador that the new GOU hoped to use a possible visit by President Bush in the near future to sign a contract between Westinghouse and EnergoAtom for the delivery of nuclear fuel. Prodan and his deputy Yuriy Nedashkovsky made the comment after the Ambassador applauded Prodan's recent public statements of support for the Ukraine Nuclear Fuels Qualification Project, in which Westinghouse fuel, with USG support, is being qualified for usage in Ukraine's Russian-built reactors. Prodan said cooperation with Westinghouse would help Ukraine strengthen energy security by allowing it to diversify its sources of nuclear fuel, all of which currently is purchased from Russia. With the qualification project moving forward, the state-owned nuclear utility EnergoAtom was making progress negotiating a commercial contract over the supply of fuel with Westinghouse. Deputy Minister Nedashkovsky said the contract was the first of its kind for Ukraine; it was far more complex than the agreements EnergoAtom had with Russia and was being examined carefully. However, the GOU was keen that it be ready for signing should President Bush visit Ukraine in April before or after the NATO summit in Bucharest, and had given instructions to EnergoAtom to expedite the negotiations with Westinghouse. Prodan expressed confidence that the timeline could be met despite these complexities.

14. (SBU) The Ambassador praised the GOU's proactive determination to accelerate the fuel qualifications project (which met some resistance under the previous government), and said the USG was willing to support the parties as they negotiate the commercial aspects of the cooperation. The signing of the commercial contract

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during a presidential visit would be a major economic and political success story. The Ambassador said he would welcome a visit by the President, and said the proximity of the Bucharest summit could provide an opportunity. He added, however, that there were still no concrete plans, and encouraged Prodan to move forward on the Westinghouse deal independently of a possible visit.

Prodan: No Alternative to RUE in the Short Term

15. (SBU) Prodan told the Ambassador that Ukraine needed to move towards market conditions in its gas dealings with Russia. That would allow Ukraine to negotiate directly with Russian suppliers and eliminate middleman RosUkrEnergo (RUE). In the short term, however, Ukraine still had no option but to use RUE. The intermediary purchased central Asian gas and sold it to Ukraine at prices that remained lower than those that Russia would charge Ukraine directly. In bilateral discussions on the gas issue, Russia regularly said it was ready to sell gas to Ukraine at the average price charged to Europe minus the transit fee, but Ukraine still could not pay such prices, Prodan said.

16. (SBU) The problem, he told the Ambassador, was that the Ukrainian economy still could not absorb a sudden rise in the price of gas to European levels. Before getting there, Ukraine needed to further modernize its economy, improve energy efficiency and develop more domestic energy sources. The new government would need to determine the timing and the path towards full market relations with Russia over gas, but "the sooner the better," he said. Any discussions over market prices for gas would invariably lead to new discussions about the proper transit fee for Russian gas crossing Ukraine to Europe. The price for imported gas would continue to rise in the coming years and soon reach world levels. In the meantime, there was no other option to the middleman solution which provided affordable gas, he maintained.

NaftoHaz

17. (SBU) Responding to a question by the Ambassador, Prodan said

that new NaftoHaz Chairman Oleg Dubyna did not travel to Moscow on January 17 to negotiate prices for gas imports or for transit fees. Prodan said the new government "was eager to learn what is happening inside NaftoHaz," the state-owned gas and oil company that might be on the verge of bankruptcy. The GOU has established an interagency committee to look into all aspects of the company's operations. The new government was acutely aware that many across the world were following the developments surrounding NaftoHaz on account of the importance of its gas transit network for Europe. Hence making NaftoHaz transparent and accountable was a priority for the new government and his ministry, he said.

Other topics

18. (SBU) On other topics, Prodan:

-- said new Deputy Prime Minister Vitaliy Haidyuk would cover industrial and economic policy as well as energy. Both NaftoHaz and EnergoAtom will be subordinated to the Ministry of Energy, although the CabMin will control the hiring and firing of the chairmen of the two companies and their deputies.

-- reiterated support for the production sharing agreement with U.S.-based Vanco.

-- criticized the current practice of selling gas to municipal utilities far below cost. Ukrainian policy was still hamstrung by the idea that domestically produced natural gas, because it was cheaper than imported gas, should somehow be sold to municipal utilities at prices far below market rates. Such thinking was bankrupting NaftoHaz and retarding the development of domestic natural gas supplies. The GOU would need to insulate the population from rising energy prices by targeted subsidies.

-- confirmed that the GOU planned to privatize more regional power distribution companies (Oblenergos). He also said Ukraine should begin privatizing power generation companies as well, particularly since "shadow privatizations" were already taking place. Further administrative regulatory and legislative steps were necessary, he said, to create the proper regulatory environment for a power sector

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based on private players.

-- gave his support, in principle, for the construction of a central storage facility for spent nuclear fuel, but otherwise remained non-committal when the Ambassador asked for his engagement to keep the project on track. (Note: U.S.-based Holtec won the tender, but progress on the project has been slow. End note.)

-- said he backed plans, developed with U.S. DOE assistance, for the disposition of highly enriched uranium currently stored at research institutes in Kyiv and Sevastopol. The National Security and Defense Council still needed to approve the plan, he said.

-- said he expected draft laws introducing green energy tariffs to be passed in the Rada. (Note: U.S. investor AES has been interested in such legislation, as it would make wind energy investments in Ukraine more viable.)

Taylor